Strategic Management Accounting (ACC 7103)

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LESSION ONE (1).

Topic One: Introduction to Strategic Management Accounting.

a) Value (Shareholder value, Customer Value, Stakeholder value)
b) The strategic management processes
c) The role of management accountants in strategic management
d) The key challenges facing management accountants
e) Analytical techniques available to management accountants include value analysis, strengths, weaknesses, opportunities, and threats; internal analysis; external analysis; and Porter's five forces model.
-Utilization of external opportunities using internal strengths: improving internal weaknesses to exploit Opportunities ; strategies to reduce the effects of existing threats in the external environment ; Using the strengths of the organization.

Origin of SMA?

1981

- Strong case for the adoption of SMA (Simons, 1981).

1990

- Cooper, Kaplan & Shank-the relevance of the SMA adoption/became accepted “Glory Decade”.

2020

- Still evolving: From Cost accounting to managerial (1945-1960) to SMA (1980)

Global Perspectives

- US: A leading US business school in the 1970s and early 1980s, and the move of many business disciplines to append “strategy” to their names – operations strategy, marketing strategy, organizational strategy.

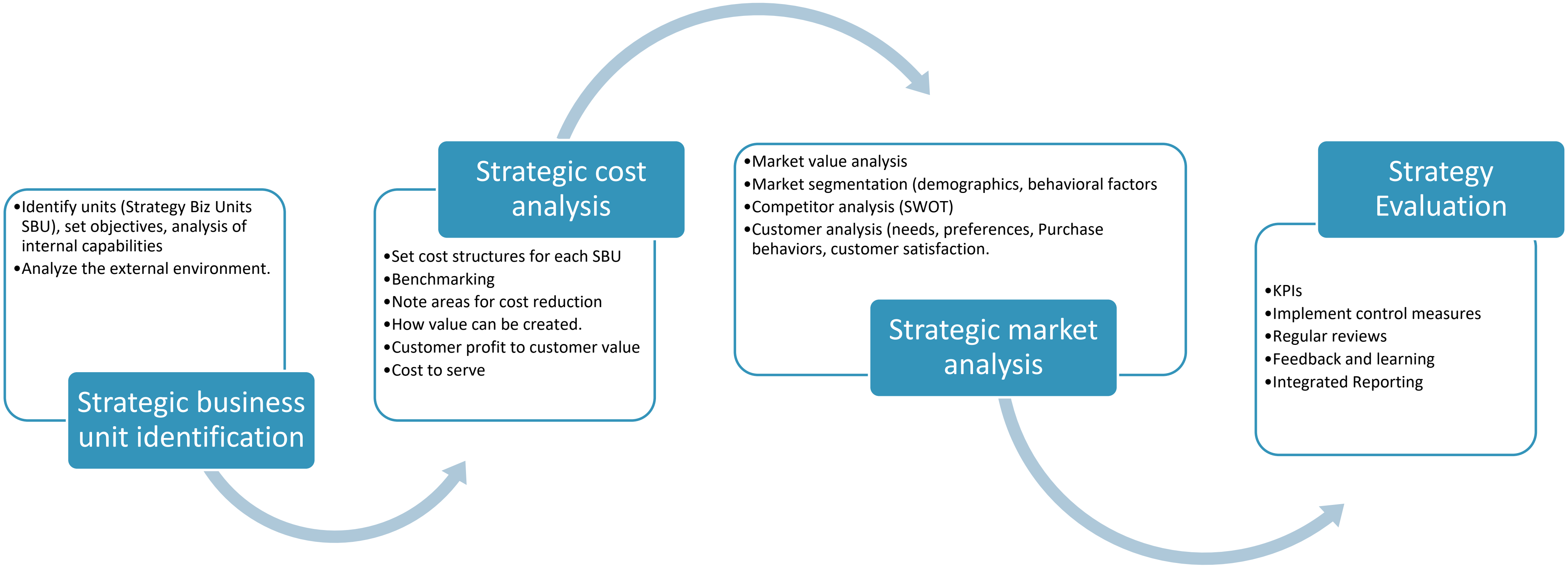
- It was inevitable for strategic accounting to emerge and supplant management accounting (Shank, 2007).

- SMA may function as an instrument that makes or breaks strategies.

Definition.

- There is no agreed definition of SMA in the literature.
- SMA is about making management accounting more strategic (Roslender & Hart, 2003).
- The provision and analysis of management accounting data about a business and its competitors, for use in developing and monitoring business strategy" (Simmonds, 1981, p. 26).
- The provision and analysis of financial information on the firm's product markets and competitors' costs and cost structures and the monitoring of the enterprise's strategies and those of its competitors in these markets over several periods (Bromwich (1990, p. 28).

SMA as a process.



(Source: Lord, 1996; Dixon & Smith, 1993).

✓Value analysis, strategic positioning analysis, and cost driver analysis

Distinguishing features that make SMA different from Cost and Management Accounting.

Feature	Strategic Management Accounting (SMA)	Cost Accounting	Management Accounting
Focus	Long-term, strategic objectives and value creation	Short-term cost control and reduction	Tactical decision-making and performance management
Scope	Broad, covering external factors, competitive analysis, and market trends	Internal cost tracking, allocation, and efficiency	Internal focus with some external financial analysis
Information Base	Combines financial and non-financial data, including qualitative factors	Primarily quantitative, focusing on financial costs	Mainly financial data with some non-financial metrics
Decision-Making	Supports strategic decisions such as market positioning and competitive advantage	Supports decisions on cost efficiency and budgeting	Aids operational and tactical decisions for internal management
Time Horizon	Long-term, forward-looking, with an emphasis on future opportunities	Short-term, historical, focused on past performance	Medium-term, often involves both past performance and future projections
Value Creation	Emphasizes creating shareholder, customer, and stakeholder value	Focuses on cost minimization and profit maximization	Supports overall business performance and internal value generation
External Focus	Strong external focus, including competitors, market trends, and regulatory environments	Little to no external focus, purely internal	Limited external focus, primarily on financial regulations and standards
Techniques	Advanced techniques such as Balanced Scorecard, Value Chain Analysis, and Benchmarking	Standard costing, job costing, process costing	Budgeting, variance analysis, financial planning
Integration with Strategy	Directly linked to the organization's strategic goals and objectives	Often disconnected from broader strategic goals	Supports management but not always integrated with strategy
Stakeholder Consideration	Considers a wide range of stakeholders, including customers, suppliers, and society	Primarily concerned with shareholders and cost efficiency	Focuses on internal stakeholders such as management and employees

The role of accountants in the adoption and implementation of SMA

- **Competitive Data Analysis**: Collecting and estimating cost, volume, and price data on competition to inform strategic decisions
- **Strategic Position Assessment**: Calculating the relative strategic position of a firm and its competitors as a basis for forming a business strategy.
- **Shareholder Value Integration**: linking corporate strategies with shareholder value analysis, ensuring that strategic decisions align with maximizing shareholder returns.
- **Acquisition Target Valuation**: Assessing the financial value of potential acquisition targets to support informed merger and acquisition decisions.
- **Cost Optimization**: identify and exploit opportunities for cost reduction, contributing to the firm's competitive advantage.
- **Cross-functional Coordination**: Bringing together different functions and disciplines within the firm.

(SMA requires a multi-functional team, where accountants work closely with operations and marketing employees)

SMA Techniques for the Individual assignment.

- Target costing,
- Life-cycle costing,
- Strategic cost analysis and strategic performance measurement systems.
- Competitor cost analysis, competitive position monitoring, competitor performance appraisal
- Activity-based costing, activity-based management (activity-based cost management),
- Attribute costing,
- Customer accounting

SMA for MSCA&F Assignment One.doc

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Hutaibat, K. (2019), "Accounting for strategic management, strategizing and power structures in the Jordanian higher education sector", *Journal of Accounting & Organizational Change*, Vol. 15 No. 3, pp. 430-452.

Alsharari, N.M. (2024), "The interplay of strategic management accounting, business strategy and organizational change: as influenced by a configurational theory", *Journal of Accounting & Organizational Change*, Vol. 20 No. 1, pp. 153-176.

Abdelmoneim Mohamed, A. and Jones, T. (2014), "Relationship between strategic management accounting techniques and profitability – a proposed model", *Measuring Business Excellence*, Vol. 18 No. 3, pp. 1-22.

Roslender, R., Hart, S. and Nielsen, C. (2024), "Strategic management accounting revisited: building on insights from the business model field", *Journal of Accounting & Organizational Change*, Vol. 20 No. 1, pp. 1-20.

Langfield-Smith, K. (2008), "Strategic management accounting: how far have we come in 25 years?", *Accounting, Auditing & Accountability Journal*, Vol. 21 No. 2, pp. 204-228.

The key challenges facing management accountants

- SMA represents the transition of accounting services and accounting professionals from the role of historically oriented record-keepers to that of action-oriented professionals who assist in senior-level decision-making.

Hint: The important changes are (a) globalization of world trade; (b) deregulation in various industries; (c) changing product life cycles; (d) advances in manufacturing and information technologies; (e) focus on environmental and ethical issues; (f) a greater emphasis on value creation; and (g) the need to become more customer-driven, (h) Pressures from Market Competition; (i) Rapid Changes in Technology; (j) New Management Accounting Tools.

The key challenges facing management accountants

Challenge	Description	Impact on Management Accounting; MA Need to
Pressures from Market Competition	Increased competition - businesses to be more cost-effective, innovative, and responsive to market demands.	To provide more detailed and timely financial analysis to support strategic decision-making under pressure.
Changes Due to Globalization	Globalization forces organizations to adapt to diverse markets, regulations, and economic conditions across countries.	To understand international financial standards, currency exchange impacts, and cross-border transactions.
Globalization	Globalization involves the integration of economies and cultures, affecting market dynamics.	Track global economic trends, and analyze their impacts on business operations, and financial performance.
Customer Focus	A shift towards customer-centric business models where customer satisfaction and experience are paramount.	Assess the financial implications of customer satisfaction strategies and measure the profitability of customer relationships.
Rapid Changes in Technology	Technology is evolving rapidly, impacting how businesses operate and deliver products/services.	Adapt to new technologies for data analysis, financial reporting, and automate routine tasks to improve efficiency.
Management Accounting Tools	The need for advanced tools to process and analyze financial data to aid in decision-making and strategy development.	Continuously update their skills to use new management accounting software and tools effectively for accurate financial insights.

Practice Question

Explain the important changes that have taken place in the business environment that have influenced management accounting practice.

Value Analysis

- Shareholder value
- Customer Value
- Stakeholder value

'Which viewpoint should be taken when determining 'value"

Value Analysis

Value is intrinsic (subjective) or objective

Puzzle: To whom, for what?

Objective view: the amount of labor needed to produce a good or offer a service (Karl Max).

Subjective view: Value begins in mind (feelings), not with the labor needed to produce a good or service (Carl Menger).

Thus, it is the client that determines the value

New call to action:

- Is what you offer valued by clients?
- Where do you find value: value pricing?
- Ascertain what is of value to your clients, why it is of value, how valuable it is, and what you need to do to help them achieve it.
- Price value focuses on both the organization and the clients squarely on what is of value to them, their priorities to fix issues or achieve results.
- More valuable: To price the value that the entity brings to the table, rather than trying to make the price the entity wants to offer.

Value Pricing

Value pricing sets the price upon how the customer perceives value and has nothing to do with internal costs.

How a client perceives the value determines their willingness to pay, and therefore, the maximum price that can be charged (the **buyer's reservation price** or **the maximum willingness to pay**).

Pricing models include hourly billing, fixed pricing, menu pricing, percentage pricing, and contingent pricing.

Every pricing model boils down to just two ways of pricing: cost-plus pricing and value pricing.

Assumptions of value pricing:

- Value pricing starts with the customer first.
- It focuses on what the customer values.
- Value is determined by the customer
- The price is set based on what the customer values. It's a win-win.
- The client wants as much value as possible,
- when more value is delivered, a higher price can be changed.

The value equation

Are your customers price-sensitive or value-sensitive?

What makes up the value

The value equation helps;

- Builds up the price packages in a better way.
- Identifies up-selling opportunities
- Spot opportunities to improve customer service
- Help the clients to see the value

Increased price, increased sales.

The value equation

Value is the positive difference between the benefits someone gets and the costs to acquire those benefits.

The cost to acquire the services is the price

Perceived value = (Perception of Tangible benefits + Intangible benefits)-Perception of cost.

- Increase the benefits more than you increase the price
- Instead of reducing the price, create more benefits
- When clients get more value, you get a better price.

- Tangible benefits: your product, your solution
- Intangible benefits: the way you deliver the solution (more powerful);
  - ✓ have emotions attached to them e.g. perception of the brand; speed of the service (waiting time); the way information is presented (content).
- Communicating the value is also important: Explain what you do; how you do it and the client benefits: crucial to the clients perception of value.

Self Assessment Quiz on Value pricing

Considering the principle that value is the positive difference between the benefits a client receives and the costs they incur, discuss how an accountancy consultancy firm can strategically utilize value pricing to enhance both tangible and intangible benefits for its clients. Specifically:

i. Identify and analyze the tangible and intangible benefits that the firm can provide to its clients. How can these benefits be enhanced to outweigh the client's perception of cost?

ii. Explore how the firm can increase the perceived value of its services without necessarily reducing prices. What are some innovative ways to create more benefits that justify a higher price point?

iii. Discuss the role of communication in shaping a client's perception of value. How can the firm effectively communicate both tangible and intangible benefits to ensure clients perceive a higher value in the services provided?

iv. What specific strategies would you recommend the firm adopt to successfully implement value pricing?

Value Chain Analysis

- The value chain is the set of activities and resources of a firm to deliver value as perceived by customers.
- The value chain is a tool that helps managers to analyze the key activities involved in delivering value to customers, enabling them to identify activities that do not add value to the process.
- From this perspective, it is important to distinguish the kinds of activities that are treasured by customers and the resources (cost) spent on the activities to satisfy customer needs (value creation).
- In all sets of activities in the value chain, Michael Porter divides the activities into two categories:
- Primary and supporting activities.
- In a value chain analysis, one needs to examine whether each activity adds value to the value chain.

Value Chain Analysis

- A summary of the value-added and core activity dimensions in a 2 × 2 diagram.
- This summary matrix expedites a directional action plan pertinent to each category of activities in the value chain.
- For example, all non-value-added activities should be eliminated in the value chain which is noncore to the company but should be minimized at all times when they are core activity (e.g., financial control, corporate management).
- all noncore but value-added activities can be outsourced to mitigate cost or save management time in managing the activities.

Value-added versus Core activity dimensions

	Value-added	Non Value-added
Non-core Activities	Outsource (e.g. IT services)	Eliminate (e.g. work redundancy)
Core Activities	Maintain / Improve (e.g. R&D, Brand Management)	Minimize (e.g. Financial Control, general Mgt.)

(a) Non-value-added activities and Cost Impact

- Non-value-added activities refer to those activities such as work duplication, resource redundancy, excess buffers, and excess support.
- These non-value-added activities are found in each major activity component (e.g., delivery, customer service)
- Noncore activities are those support functions, less critical to the operations.

Illustration One (1) on Value Chain Analysis

Gino Toys wants to know whether there is room for a price reduction of 20% for its toy products in the face of market consolidation. Gino Toys anticipates the price reduction will force the exit of its direct competitors. If Gino Toys insists on the current price level, it may lose 40% of sales volume. If it keeps up with the new market price, it may gain a further 5% growth. Gino Toys needs to prepare for the new market reality and questions whether there is room for operation improvement.

Gino Toys hired you as an external consultant to conduct a value chain analysis.

In particular, Gino Toys wants to:

(a) Identify non-value-added activities in the value chain and their cost impact.

(b) Evaluate the cost, volume, and profit impact of the price change.

© Explore the potential room for cost improvement.

Additional Information: Assume the current price per toy is $100

Assume the current cost per toy is $60.

Assume the current sales volume is 100,000 units.

Strategic Management Accounting Analytical techniques

- Strategic cost analysis
- Managing customers
- Competitor analysis
- Managing corporate value
- SWOT analysis
- Internal analysis
- External analysis
- Porter's Five Forces model

MAKERERE UNIVERSITY BUSINESS SCHOOL

FACULTY OF COMMERCE

DEPARTMENT OF ACCOUNTING

ASSIGNMENT ONE (1)

Course name	:	Strategic Management Accounting
Semester	:	One
Course code	:	ACC 7103

Key Techniques of Strategic Management Accounting

In today's dynamic and competitive business environment, organizations must continuously seek ways to enhance performance and create value for various stakeholders. Strategic management accounting (SMA) has emerged as a critical tool, enabling businesses to align their financial strategies with broader organizational goals. SMA techniques, such as Value Chain Analysis, Balanced Scorecard, Benchmarking, Target Costing, and Activity-Based Costing (ABC), provide comprehensive frameworks for assessing and optimizing different business operations.

Instructions:

(i) Clearly define each of the following key techniques of strategic management accounting:

- Value Chain Analysis
- Balanced Scorecard
- Benchmarking
- Target Costing
- Activity-Based Costing (ABC)

(ii) Discuss the underlying assumptions of each technique. What are the key premises or conditions assumed to be true for each technique to be effectively applied?

(iii) Describe the practical reality of implementing each technique. What are the key activities involved in the application of these techniques within an organization?

(iv) Analyze the advantages and disadvantages of each technique. What are the benefits of using these techniques, and what challenges or limitations might organizations face (What explains the slow take-up of SMA techniques)?

(v) What evidence do you have about the adoption and use of SMA in Ugandan Firms?

Reading Required

Anderson, M., Khan, S., Mashruwala, R., & Yu, Z. (2023). Resource-based Commitment to a Customer-centered Strategy. In *Advances in Management Accounting* (pp. 159-180). Emerald Publishing Limited.

Strategic Cost Analysis (SCA)

- The essence of a successful organization is the ability to plan and control costs and to have the information to make viable financial decisions.
- Managers need data that are relevant to their responsibilities.
- Managers need data that are relevant to their responsibilities (engaging, manipulating, and analyzing cost information).
- SMA is not just a method of data collection but an important indicator of how to better manage the organization in pursuit of its strategy.
- SCA helps companies identify, analyze, and use strategically important resources for continuing success (Juras & Peacock, 2006).
- SCA is about helping organizations succeed, and this means employing different cost management techniques in different circumstances.
- SCAs are designed to satisfy the needs of managers within an organization,
  - ✓ the application and terminology of specific costing methods and techniques may develop within the culture of that organization. Key techniques; the value chain, a balanced scorecard, and added economic value).

Assumptions of Strategic Costs Analysis (SCA)

1. The technique focuses on an organization's various activities;
   - ✓ Identifies the reasons for their costs, and
   - ✓ Evaluate strategies for creating a sustainable competitive advantage.

2. The technique provides organizations with the total costs and revenues of strategic decisions.
   - ✓This requires creative thinking, and managers need to identify and solve problems from an integrative and cross-functional viewpoint.

3. Strategic cost accounting is entirely a voluntary practice carried out by organizations.
   - ✓no rules or regulations for the conduct (unfettered by regulations).

4. SCA is externally as well as internally focused.

5. SCA is for both the short-term and long-term management of an organization.

Examples of SCA

- Deciding on product mixes and production volumes
- Outsourcing decisions
- Cost reductions
- Investment and profit growth in different markets
- Responses to suppliers’ and competitors’ activities
- Changes in consumer demand

The Four Key Questions

1. **What Did It Cost and Why?**
   - ✓ "It" is the cost object; anything for which cost data are required.
   - ✓ E.g labor, materials, products, services, Departments, activities
   - ✓ specify the nature of the cost; cost of material used; cost of the machine time taken in manufacturing

   Why: To know the particular cost, and how to analyze the data effectively to enhance managerial performance.

2. **What Should It Have Cost?**
   - ✓ This is about setting standards and conducting comparisons
   - ✓ The present cost can be compared with the following:
     - Previous costs for the same activity
     - Costs for alternative courses of action; outsourcing or switching to different products or processes.
     - Planned costs; predetermined costs for a specific period
     - Costs of external organizations; difficult but strategic competitiveness should be a part of an organization's portfolio.

The Four Key Questions

3. How Can We Improve?

- Relates to change that involves determining appropriate financial measures for a particular activity and monitoring changes in performance.
- Establishing appropriate measures usually presents problems, and a variety of solutions can be employed.
- Managers can focus on how to manage the performance of their responsibility area
- Conduct Performance measures; related to costs incurred and can be compared.

4. What Is Our Next Strategic Move?

- ✓ No matter your role in an organization, your performance is tied to the corporate strategy, and play a part in shaping it.
- ✓ What is your contribution?
- ✓ Whether in a service firm or manufacturing; the benefits of cost and complexity reduction can decrease the financial outlay in bringing the product or service to the customer.
- ✓ Consider customer demand and recognize local and global business conditions and economic events.

The Four Key Questions

1. What Did It Cost and Why?

- Classify the cost object.
- Cost unit
- Specify the nature of the cost.
- To enhance managerial performance

2. What Should It Have Cost?

- Setting standards
- Conducting comparisons with the present

✓Previous cost
✓Cost of the alternatives
✓Planned costs
✓Cost of the Competitor

3. How Can We Improve?

- Managers are Champions of change.
- Managing the performance of each responsibility area
- Conducting Performance measures

4. What Is Our Next Strategic Move?

- Strategic approach required by Managers in organizational roles,
- Focusing on efficiency, contribution,
- Awareness of external factors.

Making the Fit ~SCA

- Managers in the organization decide the types of cost information they require.
- This structuring of the system by managers is known as contingency theory,
- Contingency theory postulates that organizational structures and systems are a function of environmental and firm-specific factors.

Factors generally shape the costing system:

- ✓The type of organization, that will include such considerations as size, structure, and purpose
- ✓The organizational constituents, who may be investors, shareholders, the local community, and society at large
- ✓The output from the activities, which may be tangible manufactured goods, services, or even professional advice
- ✓The information needs of the manager, which will depend on the manager’s role and responsibilities

“These factors determine the techniques selected when presenting information in a form that can be analyzed to support and monitor strategic decisions”

The Process of Strategic Cost Analysis
(*Three steps are advised (Al-Hazmi, 2010, p.33*)

1. Auditing both existing and planned cost initiatives

To ensure that the proposed changes improve the organization’s strategic cost management

2. Extending the scope of internal costing beyond the walls of the factory.

a manufacturing, service, or public organization

Investigate the departments and activities that would be managed more successfully

3. Extending the cost management program beyond the boundaries of the firm.

Consider the external environment

The process of strategic cost Analysis should therefore;

- Build on the core competencies of the organization
- Identify the costs that are relevant to its needs
- Generate valuable comparisons with its plans
- Support the search for improved performance

Strategic Cost Analysis Functions

Managers need Strategic cost accounting to perform these functions;

i. **Identifying Costs**

- ✓ Common phrase “different costs for different purposes.
- ✓ implication of this is that each management purpose or objective requires specific cost identification and will require appropriate costing methods and techniques.
- ✓ The purpose of a costing system is to “help guide management in making decisions on how to best use these limited resources strategically

ii. **Comparing with Plans**

- ✓ Comparing actual with predetermined performance,
- ✓ management can make assessments and conduct investigations to remedy deficiencies and promote good practices.
- ✓ Comparing with plans is therefore part of a control loop; the plans should lead to action (degree of predictability of the capacity; stability of the marketplace)
- ✓ By comparing the actual performance against plans, you can assess your managerial abilities.

Strategic Cost Analysis Functions

Iii. Seeking Improvements

- know how you can improve your performance.
- A range of techniques have been developed and are still being generated to support managers improve
- Improving the company's performance is geared to the external economics and the internal dynamics.

iv. Performance Measurement; What to Measure

- Metrics used to assess how you have performed as a manager are normally based on some form of comparison of the actual costs, revenues, or profits against a predetermined amount.
- These are usually the financial components of the agreed strategy.
- Demonstrate improved performance by maintaining the quality of the activity but reducing the costs or improving the quality while maintaining the cost level.
- In some circumstances you can reduce cost levels and simultaneously improve quality.

"For example, a printing department may start charging for leaflets and brochures it produces for other departments.

The user departments may then decide to try for external competitive quotes and, if they choose this and accept them, this will reduce the "income" of the print department"

Sometimes a strategic decision is made to change a cost center into a profit center to avoid these problems.

Strategic Cost Analysis Functions

v. **You Get What You Measure; Performance Rewards**

- Cost systems affect behavior in the workplace because they either explicitly or implicitly recognize or reward the performance of managers.
- E.g Bonuses, career progression, and even slaps on the back and congratulatory words are likely to direct a manager’s efforts and behavior.
- The direction followed will be what is being measured and rewarded. This can be in conflict with what is required to achieve organizational strategy.
- To measure the performance required from employees, some companies construct an array of KPIs to minimize attention being focused on just one aspect of performance to the detriment of other important aspects.
- **Imagine;**

✓ If the performance of a salesperson is measured based on the number of new customers obtained, there will be a tendency to concentrate on that and ignore maintaining a good relationship with existing customers.

✓ If employees are paid a bonus on the volume of work they achieve in a certain time, there may be a lack of attention to quality unless that is also measured in some way.

- Care needs to be taken, and KPI must satisfy these five criteria (SMART).
- Costing is not just about numbers. It is about the activities of people and their endeavors to use the resources for which they have a responsibility to achieve an agreed strategic goal.

Self Assessment:

- Consider the different types of organizations and how the nature of their activities influences cost methods and techniques.

- Explain the need for different forms of cost information to plan, control, and make decisions.

Calculating the total cost of a particular product or activity.

Two primary methods for calculating the total cost of a product or service:

- Full costing and activity-based costing (ABC).
- How each of these two methods is applied depends on whether you are working for an organization that has a specific order of operations or one that has continuous operations.
- In a large organization, there may be both production and service activities of varying natures.

1. The Nature of Costs: Cost Classification;

- Classifications are used in all walks of life.
- For example, a group of people can be classified by gender, age, and weight.
- Cost classification may be determined by the reason for requiring the information.

Classification	Explanation	Examples
Nature	The main headings are materials, labor, and overheads.	Raw materials, work in process, supervisory staff, depreciation, insurance
Function	The purpose of the cost, which is usually aligned to cost or profit centers.	Administration costs, production costs, distribution costs
Product costs	These are costs that can be directly identified with a particular product or service.	Raw materials or bought-in parts in manufacturing, costs of staff in an accounting or law firm
Period costs	These are costs that are related to a financial period.	Insurance for the buildings, salaries of administration staff
Direct costs	These are costs that can be identified with a specific cost object that is a particular product, department, or other cost object.	Raw materials used in production and labor where it can be traced to that particular activity

Classification	Explanation	Examples
Indirect costs (overheads)	These cannot be identified with an individual cost object but may be organization wide.	Supervisor salaries, heating in the buildings, telephone costs
Variable costs	This is a behavioral classification, and these costs change in total as activity changes.	Materials used in making the cost object
Fixed costs	This is a behavioral classification and refers to those costs that stay the same in total regardless of changes in levels of activity.	Rent, insurance
Mixed cost	A semivariable cost that varies with volume but not in proportion to volume.	Telephone bills that include a fixed charge for basic service plus a variable charge for long-distance calls

2. Cost Pools and Cost Allocation

- An activity cost pool is a set of costs that are incurred when certain operations are performed within the organization (cost center).
- By accounting for all the costs incurred in a specific activity within a pool, it is simpler to assign those costs to products and get an accurate estimate of production costs.
- An activity cost pool is an aggregate of all the costs required to perform a task such as production.
- Cost allocation involves identifying the costs of different cost objects. A cost object is an item for which a business wishes to separately estimate cost.
- This could be a special project, a department, a branch, or a customer.
- It involves identifying the cost object and assigning all the costs caused by that cost object to it.
- Cost allocation is important because it is the process through which costs incurred in producing a certain product or providing a service are calculated.
- If a company is using **strategic cost analysis**, costs must be accurately calculated and allocated.
- If the cost of a product or service is not correctly allocated, it may be offering products or services at a price that is too high and therefore not marketable or too low and a loss is being made.

3. Ascertaining the Total Cost

1. Full Costing or Absorption Costing

- There have been attempts to calculate the full costs of an organization’s activities by including social, environmental, and economic costs/ the triple bottom line by John Elkington.
- We restrict the use of the term “full costing,” also known as absorption costing or traditional costing, as a cost accounting method designed to identify the material, labor, and overhead costs incurred to provide a product or service.

The purpose of the technique is to find the total cost, including overheads, of the cost object.

Full costing seeks to provide answers to two practical problems:

- How to share the total overheads of the organization over the various production cost centers.
- How to share the overheads for a particular production cost center over the various products passing through it.

The stages of sharing organizational overheads under full costing

- Charge those overheads to the department that causes them.

- Share the remaining overheads over the departments by preparing an overhead analysis statement.

- Charge a share of the departmental overhead to each cost object passing through it to give the total production cost of each cost object.

Example of Overhead Analysis Statement and Allocation Rate

Assume that there are just two production departments in the factory, and the production goes first to Department 1 and is completed in Department 2.

Table 1. shows the characteristics of the company.

	Total	Department 1	Department 2
Number of employees	20	15	5
Area (sq. feet)	1,000	800	200

Factory Overhead	Rent	Supervisors' salaries	Building Insurance	Total
Budgeted Overhead (thousand Dollars)	40	60	10	110

Required;

i. Calculate the total overhead
ii. Calculate the total overheads for each department,
iii. Assign the overheads to Departments 1 & 2 based on the respective basis of apportionment.

RECALL: TYPES OF COST SYSTEM

Costing systems can vary in terms of which costs are assigned to cost objects and their level of sophistication. Cost systems are classified as follows:

1) Direct costing system;
2) Traditional absorption costing systems/ Full costing system;
3) Activity-based costing systems.

TYPES OF COSTING SYSTEMS

- Direct costing systems only assign direct costs to cost objects.
  - Because they do not assign indirect costs to cost objects they report contributions to indirect costs.
  - Periodic profitability analysis would thus be used to highlight negative or low-contribution products
  - Direct costing systems can only be recommended where indirect costs are a low proportion of an organization's total costs
- Both traditional and ABC systems assign indirect costs to cost objects.
  - Full costing system allocates overheads to production and service cost centers (typically departments) and then reallocates service department cost center costs to the production departments.
  - ABC system assigns overheads to each major activity (rather than cost centres or departments).

Activity-Based Costing (ABC)

- ABC is a costing system in which costs are first assigned to pools, and then cost drivers are used to calculate the total cost of specified activities.

- ABC offers the advantage of more accurate information than absorption costing because it looks for a closer relationship between overheads and the cause of these indirect costs.

- ABC as a valid alternative to full costing appeared in 1987 by Kaplan and Bruns.

ACTIVITIES

Activities consist of the aggregation of many different tasks, events or units of work that cause the consumption of resources.

Mostly consists of verbs associated with objects.

- Production process activities include machine products and assembly products.
- Typical support activities include: scheduling production, setting up machines, moving materials, purchasing materials, inspecting items, processing supplier records, and expediting and processing customer orders.
- Instead of using the terms ‘allocation bases’ or ‘overhead allocation rates’ the term cost driver is used by ABC systems.
- A cost driver represents a measure that exerts a major influence on the cost of a particular activity such as the number of production runs for production scheduling and the number of purchase orders for the purchasing activity.

ABC Paradox

- ✓White, Anistal, and Anistal (2015) found that the adoption of ABC is promising in developing nations and some American and European business sectors,
- ✓There is a gap between the claims made on behalf of the method and the actual rate of adoption.
- ✓Identifying the rate of adoption of ABC is that companies devise, structure, and implement any costing system to meet their own strategic needs.

MEASUREMENT OF INDIRECT RELEVANT COSTS FOR DECISION-MAKING USING ABC

- The treatment of direct costs is the same as full costing.
- The purpose of ABC: To ascertain the total cost of a product, service, or activity, but the approach it adopts differs from full costing.
- Instead of being based on functional departments or responsibility centers, ABC uses the concept of “cost pools.
- Instead of allocation rates to charge overheads to the products, cost drivers are identified.
- The main activities in the organization are classified into activity centers or cost pools.

DESIGNING ABC SYSTEMS

Four steps are involved. They are:

1) Identifying the major activities that take place in an organization;
   - Activities are the aggregation of many different tasks, events, or units of work that cause the consumption of resources.
2) Assigning costs to cost pools/cost centers for each activity;
   - To determine how much the organization is spending on each of its activities (based on cause-and-effect cost drivers)
3) Determining the cost driver for each major activity; Factors for selecting a suitable cost driver;
   - It should provide a good explanation of costs in each activity cost pool.
   - A cost driver should be easily measurable; the data should be relatively easy to obtain and be identifiable with products.
   - Activity cost drivers consist of transaction drivers (the number of times an activity is performed) and duration drivers (the amount of time required to perform an activity).
4) Assigning the cost of activities to products according to the product's demand for activities- applying the cost driver rates to products.

Values & Pitfalls

VALUES

- ABC incorporates all relevant overheads and generates information that enables managers to make better decisions about the management of those activities and the possibilities of cost reduction.
- ABC is probably best suited for organizations where traditional full costing will not provide the information required.
- The method seems to have been particularly beneficial in the service industries and has been implemented by financial institutions and hospitals.

PITFALLS:

- The cost of implementing and managing a new system may seem too burdensome to make it worthwhile.
- A large component of the cost may be fixed although there are changing activity levels. ABC, like full costing, relies on the accuracy of the predictions concerning the amount of the overhead and the level of the activity.
- Assumes that the activities are homogeneous: All machine setups take the same time to carry out; are differences in the time taken for setups

ACTIVITY HIERARCHIES

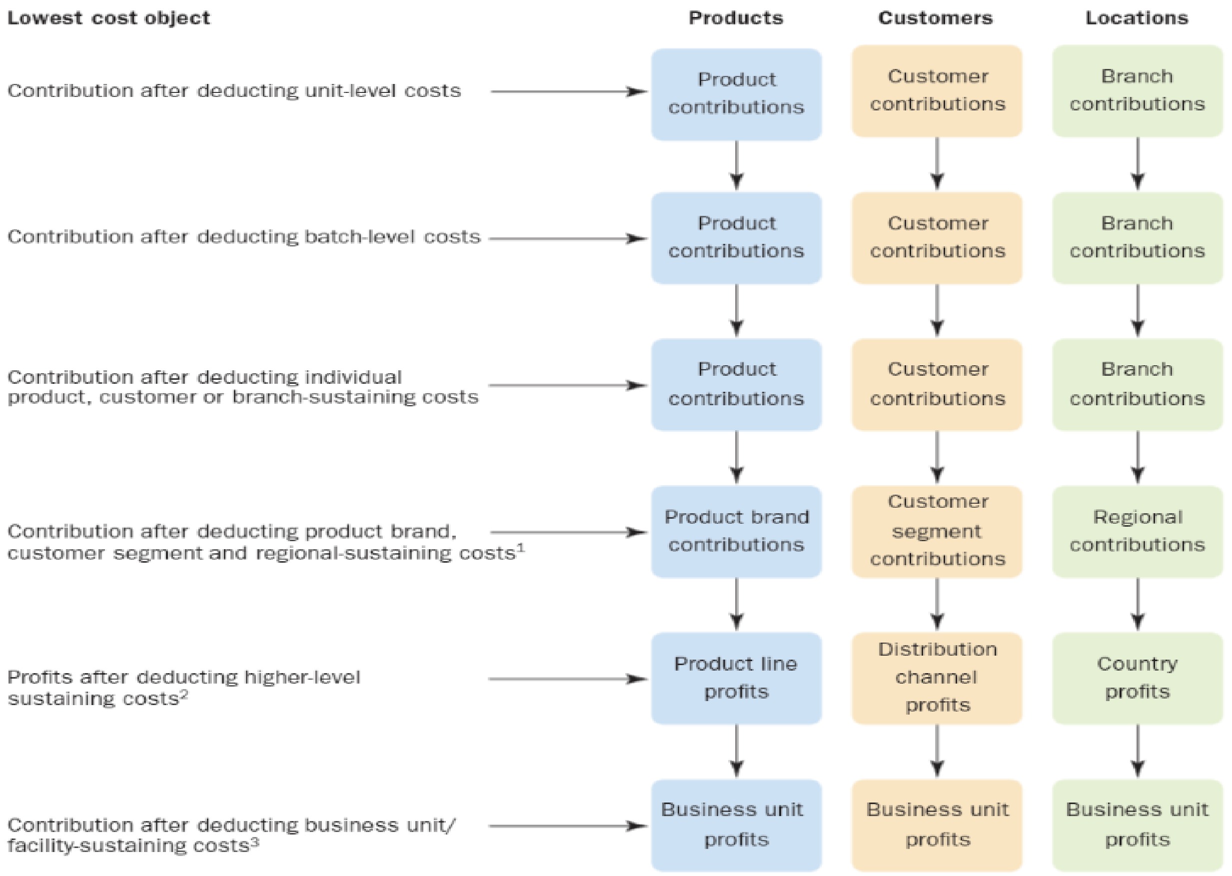
ACTIVITY HIERARCHIES	Cost hierarchy dimension
1. Unit-level activities (volume-related activities)	- performed each time a unit of the product or service is produced.
	Unit-level activities consume resources in proportion to the number of units of production and sales volume.
	Cost drivers for unit-level activities include labor hours, machine hours, and the quantity of materials processed
2. Batch-related activities	such as setting up a machine or processing a purchase order, are performed each time a batch of goods is produced.
	The cost of batch-related activities varies with the number of batches made but is common (or fixed) for all units within the batch
	For example, set-up resources are consumed when a machine is changed from one product to another
	As more batches are produced, more setup resources are consumed
3. Product-sustaining activities or service-sustaining activities	Performed to enable the production and sale of individual products (or services).
	Examples of product-sustaining activities include maintaining and updating product specifications and the technical support provided for individual products and services
	The costs of product-sustaining activities are incurred irrespective of the number of units of output or the number of batches processed, and their expenses will tend to increase as the number of products manufactured is increased
	Where customers are the cost objects the equivalent term for product sustaining is customer-sustaining activities.
4. Facility-sustaining (business-sustaining activities)	Performed to support the facility's general manufacturing process and include general administrative staff, plant management, and property costs.
	They are incurred to support the organization as a whole and are common and joint to all products manufactured in the plant.
	Costs should not be assigned to products since they are unavoidable and irrelevant to most decisions. Instead, they are regarded as common costs to products made in the plant and deducted as a lump sum from the total operating margins of all products

Hierarchical ABC profitability analysis

Cooper and Kaplan (1991) have applied the ABC hierarchical activity classification to profitability analysis.

- The general principles of activity profitability analysis is applied to different cost objects.
- This approach categorizes costs according to the causes of their variability at different hierarchical levels.
- Hierarchies identify the lowest level to which cost can meaningfully be assigned without relying on arbitrary allocations.
- The lowest hierarchical levels are product, customer, and branch contributions after deducting unit-level costs, and, ignoring the business unit level,
- The highest hierarchical levels are product lines, distribution channels, and country profits.

An illustration of hierarchical ABC profitability analysis



***Let us initially focus on products as the cost object*.**

- For products as the cost object; a unit-level contribution margin is calculated for each individual.
  - ✓ This is derived by deducting the cost of unit-level activities from sales revenues.
- Unit-level contribution expenses relating to batch-related activities are deducted.
- The costs of product-sustaining activities are deducted.
- Thus, three different contribution levels are reported at the individual product level.
- Differentiating contributions at these levels provides a better understanding of the implications of product mix and discontinuation decisions in terms of cost and profit behavior.

Comparison of full costing and ABC

Factors	**Full costing**	**ABC**
a) Establishing the budget for overhead costs	✓ Identify cost or profit centers over which total overheads will be shared	✓ Identify activity pools to which overheads will be collected.
	✓ Decide on the allocation rate for each cost center e.g. machine hours, about hours, or cost units	✓ Decide on the cost drivers for each activity pool e.g. number of orders placed to purchase supplies.
a) Charge direct costs to the job, process, service or activity	✓ Charge indirect costs to products, jobs, or services using the allocation rate.	✓ Charge indirect costs to the activity pool using the cost driver.
a) Add direct costs and indirect costs to find the total cost of the product, job, process, or service.		

Examples of cost pools and drivers

Cost pool	Cost driver
Procurement of supplies	Number of orders placed
Machine setup costs	Number of different jobs run
Handling of materials	Quantity or weight of materials handled
Sales administration	Number of customer orders auctioned

Time-Driven ABC (TDABC)

- The major weakness of ABC has been the compilation of the time taken by various activities in an organization with individuals undertaking those activities.
- Not all businesses are suited to ABC; the ABC adoption rate has been fairly low.
- The costly design, implementation and operation of such systems have been the major contributory factors explaining the rate of adoption
- In a large organization, this can be very time-consuming and expensive.
- To overcome these problems Scholars advocate adopting traditional ABC by using a more simplistic approach called time-driven ABC

The proposed model simplifies ABC in two ways.

First, managers are required to estimate resources by each product, transaction, or customer.

- Two estimates are required: the cost per time unit of supplying resource capacity and the unit time of resource capacity consumption by each product, transaction, or customer.
- This provides additional information on how many minutes staff members spend on activities in a particular period.
- Time-driven ABC overcomes the difficulties and costs of implementing and maintaining a traditional ABC system and provides managers with cost and profit information quickly and inexpensively.

Available evidence suggests;

- **TDABC** is more appropriate and easier for companies operating in the service sector to implement than manufacturing companies.

- This is because capacities are generally measured in labor time and this could be easier in service companies because the capacities are generally measured in terms of labor time.

Example Calculating the Total Cost under the two approaches "Traditional ABC and Time-Driven ABC"

A traditional ABC system for a customer services department with a quarterly total expenditure of UGX 560,000 (consisting of the cost of personnel, information technology, and other fixed expenses) involving three activities; processing customer orders, handling customer orders and performing credit checks.

Employees are surveyed to estimate the percentage of time they expect to spend on the three activities and the department's expenses are assigned to the activities based on the average percentages derived from the survey. The quantities of work for the three activities, the cost drivers, are obtained to derive the cost driver rates.

the cost per time unit of supplying resource capacity;2 the unit times of consumption of resource capacity by products, services or customers.

Self assessment

Describe the three different types of cost system that can be used to assign costs to cost objects

Define activities and cost drivers.

What factors led to the emergence of ABC systems

Identify and explain each of the four stages involved in designing ABC systems

Describe the ABC cost hierarchy.

Distinguish between traditional ABC and time-driven ABC

Describe the ABC profitability analysis hierarchy.

Strategic Management Accounting (ACC 7103)

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Practice Questions on Total cost and Profit Analysis

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SWOT analysis: Internal and External factors

- The SWOT analysis is a multidimensional tool for strategic analysis:
- Uses: This model allows organizations (businesses, public administrations, or associations) to quickly identify both the internal factors linked to internal functioning and external factors that depend on the environment in which it is evolving.
- A decision-making tool and facilitate the development of strategic plans.
- The power of the SWOT analysis lies in its simplicity (simple to use), it also collects results that can be easily communicated to the public.
- The key factors that should be taken into account to identify the **strengths and weaknesses** of an organization (Cost competitiveness, Network and distribution capacity, Sales and marketing, Financial resources, Human resources, Innovation policy). Controllable.
- **Threats and opportunities**/ External environment: Economic climate, Global consumer trends, Competitive environment, Regulatory environment. Can not be controlled.
- **Critiques (Research)**

Five Steps For Success With The Swot Analysis

1. Identify strengths.

Identify the elements that have a positive influence on the performance of the organization and are linked to the internal functioning e.g the performance of its distribution channel, its brand image

2. Identify weaknesses

Identify the elements that have a negative influence on the performance of an organization and those linked to the internal functioning e.g weak capacity for innovation, bad communication and an incapability to reduce costs

3. Identify opportunities

External factors of an organization that could have a positive influence e.g competition, economic context, legal and demographic

4. Identify threats

Identify external factors of an organization that could have a negative influence.

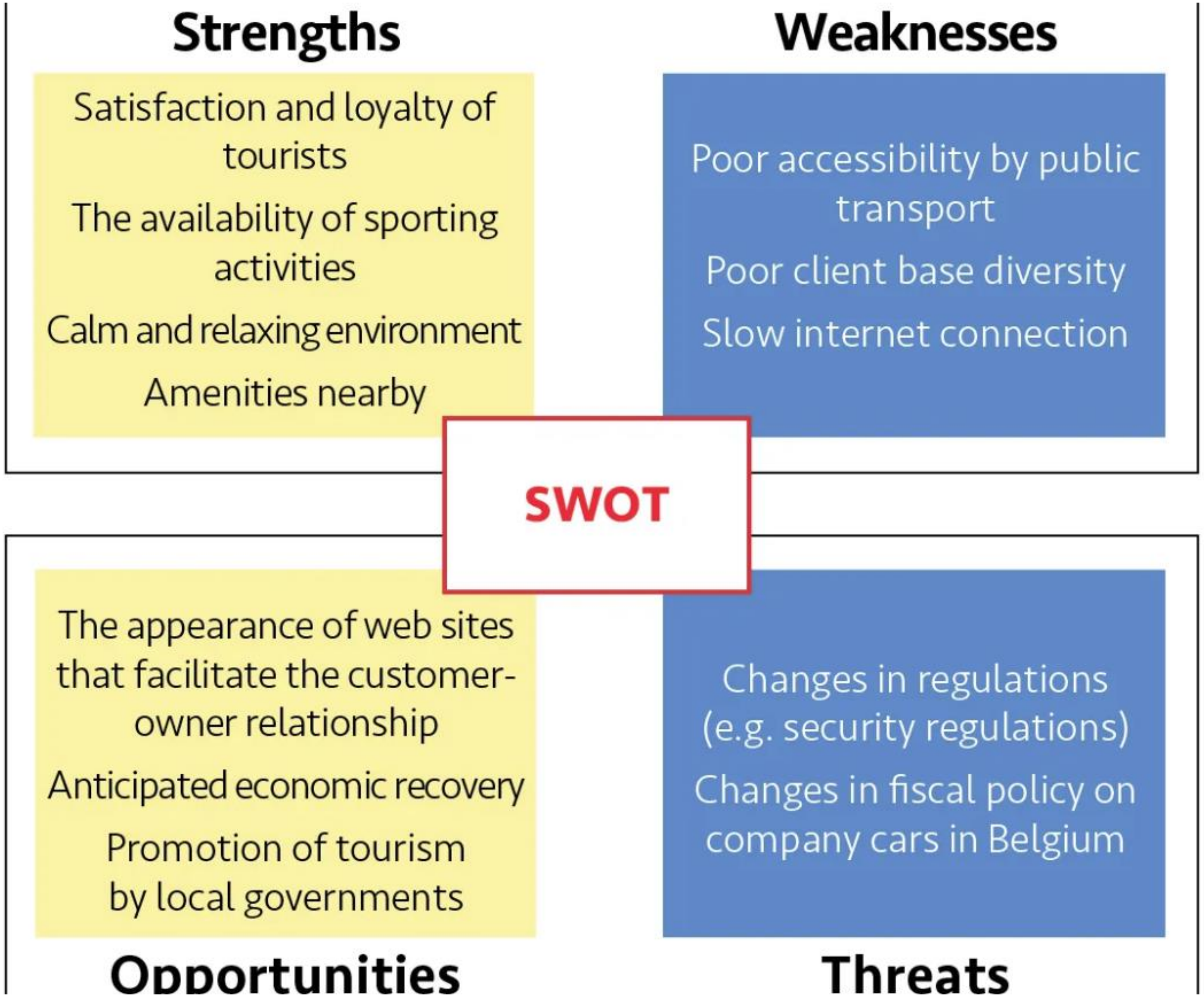
5. Establish a strategy

Once all of the internal and external factors are identified, the decision-making phase can begin

Case Study – Tourism Organization in the South Of France

The organization studied is a small tourism organization managed by a couple. They own three guest houses located in the south of France, on the border of the Alps and Provence. Identified as a tourism organization, they attract a customer base that is mainly foreign, particularly in summer. One of the major problems affecting this tourism organization is the irregularity in demand according to the season. The occupancy rate is close to 100% in July and August, yet it barely reaches 30% during the rest of the year. The occupancy problem is directly linked to the external environment of the company since the couple running the guest houses doesn’t have any control over the holiday of customers. However, other factors can be adjusted and thus controlled internally to influence the choices of tourists.

Explain how a SWOT analysis can help to enhance this Tourism organization.


Strengths
Satisfaction and loyalty of tourists
The availability of sporting activities
Calm and relaxing environment
Amenities nearby
Weaknesses
Poor accessibility by public transport
Poor client base diversity
Slow internet connection
SWOT
The appearance of web sites that facilitate the customer-owner relationship
Anticipated economic recovery
Promotion of tourism by local governments
Opportunities
Changes in regulations (e.g. security regulations)
Changes in fiscal policy on company cars in Belgium
Threats

Other alternatives to the SWOT analysis

Other models have been developed to facilitate the establishment of strategic management accounting;

a) The five forces model by Micheal E. Porter focuses mainly on the constraints that negatively influence the profitability of the business

b) The models of French economists Antoine Augustine Cournot and Joseph Bertrand enable the thorough analysis of competition in the required context (19th century).

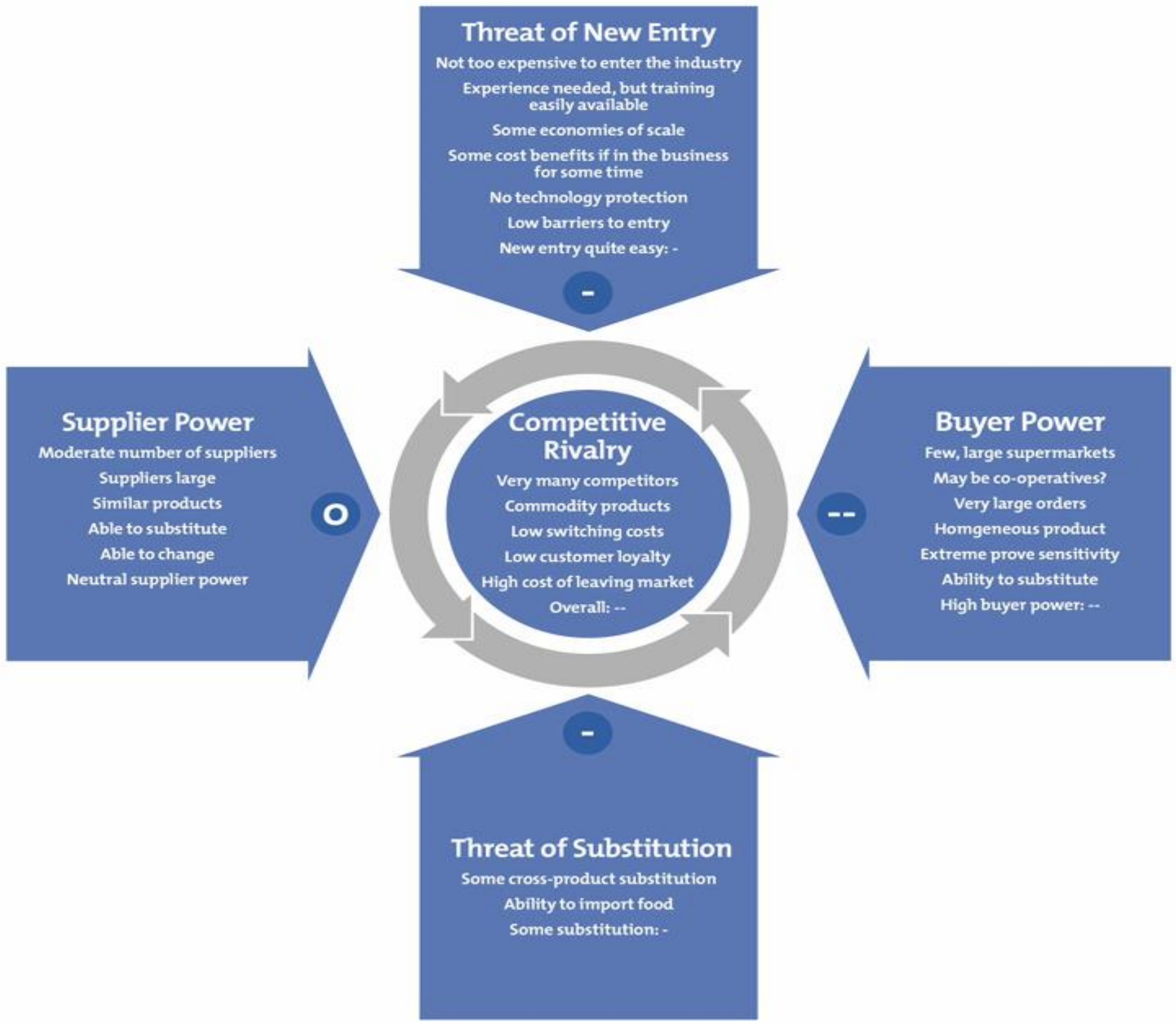
The Five Forces Model
Competitor analysis: “Activity-based view”

Porter’s contention that the following competitive forces affect a company’s profits:

Porter’s five forces model enables a company to analyze its competitive environment.

It identifies five forces that can influence an industry’s competitive landscape.

1. The threat of new entrants into an industry or market served by a specific company
2. The bargaining power of suppliers
3. The bargaining power of the consumer
4. The threat of substitute products or services
5. The intensity of rivalry among existing firms



- When is Supplier bargaining power likely to be high?
- When is Customer bargaining power likely to be high?
- The threat of new entries will depend on the extent to which barriers to entry.
- What factors determine the threat of new entrants and the threat of substitutes?
- When is Competition between existing players is likely to be high

Three strategies

- Porter's thesis is that if a company is to be successful, it must adopt a strategy that combats these forces better than the strategy developed by its rivals.
- To do this, a company has a choice of three strategies: cost leadership, product differentiation, and focus or niche.
  - **Cost leadership**, the organization offers the market products or services at a low cost compared with that of competitors; involves price cutting (The biased price-quality relationship).
    - ✓ the lowest delivered cost to a customer; increases profit margins at the prevailing level of industry prices; the price leader.
  - **Product differentiation**, the organization's products or services are considered by customers as superior to that of competitors, and therefore a premium price for the goods or services can be demanded (The trade-off on value)
    - ✓ companies to improve their profit margins by charging higher prices for a product

Product differentiation

- Differentiating products and services is how consumers are given choices and how companies build their brands.
- Differentiation creates marketplace variety and interest. A well-differentiated product or service can increase consumer satisfaction and the prices customers are willing to pay.
- Price premiums improve company profitability and allow companies to invest in growth.
- So in theory, differentiation can improve the fortunes of consumers and companies alike.
- **Painful game**; many companies fail to enjoy the benefits because;
  - ✓ Products or services are just not seen by consumers as meaningfully different or better than other products or services.
  - ✓ A hypercompetitive, ultra-transparent modern world puts pressure on companies to continually innovate but to do so in a relevant manner, to create differentiation.
  - ✓ Failure to innovate and stay relevant can lead to erosion in differentiation and a commoditization hell,
  - ✓ where gains and losses are driven solely by costs and prices and there are no real winners.
  - ✓ The solution is clear: differentiation is key.

Making the Fit of the Strategies.

- Caution must be exercised in assuming whether an organization should use a cost leadership or a product differentiation strategy.
- Once the corporate-level strategy has been decided, managers must implement it at the business or operational level.
- Require planning, making decisions, and controlling activities to achieve the desired strategy.
- Strategic differentiation
of your business model consistently brings higher returns than making cost-
cutting process improvements or adding product features that competitors can readily match."
- Differentiation must span the entire organization.

Self Assessment

Cost is a slippery term, so you need to;

- ❑ Be specific on what is being costed
- ❑ Know what the cost should be
- ❑ Understand how performance can be improved
- ❑ Set the information within the organization's strategy

Managing customers: Customer Value Analysis

- **The customer value creation formula (and process)**
- **Reinventing the business model and making it customer-centric (**Customer orientation).
- In order to survive in today's competitive environment, companies have had to become more customer driven and to recognize that customers are crucial to their future success.
- They are being encouraged to look outward at customer requirements and reflect that internally, rather than only inward at their own operations.
- This has resulted in companies making customer satisfaction an overriding priority and to focus on identifying and achieving the key success factors that are necessary to be successful in today's competitive environment.

FOCUS ON CUSTOMER SATISFACTION

- The key success factors that organizations must concentrate on to provide customer satisfaction are cost, quality, reliability, delivery, and the choice of innovative new products.
- In addition, firms are attempting to increase customer satisfaction by adopting a philosophy of continuous improvement to reduce costs and improve quality, reliability and delivery;
- **Cost efficiency**; Keeping costs low and being cost efficient provides an organization with a strong competitive advantage.
- **Quality**; In addition to demanding low costs, customers are demanding high-quality products and services. Most companies are responding to this by focusing on total quality management (TQM).
- **Reliability** refers to the consistency and dependability of a product or service. Customers expect products that perform well over time and services that are consistently available.
- **Delivery** refers to both the timely provision of goods or services and the logistics of getting products to customers. This includes speed, accuracy, and convenience of the delivery process.
- **Choice of Innovative New Products;** Offering innovative products means continuously improving or launching new solutions to meet changing customer needs. Innovation helps companies differentiate themselves from competitors.

Time as a competitive weapon

- Organizations are also seeking to increase customer satisfaction by providing a speedier response to customer requests, ensuring 100 percent on-time delivery, and reducing the time taken to develop and bring new products to market.
- For these reasons management accounting systems now place more emphasis on time-based measures, such as **cycle time**.
- Time (T) consists of the sum of processing time, move time, wait time, and inspection time.
- Only processing time adds value to the product, and the remaining activities are non-value-added in the sense that they can be reduced or eliminated without altering the product's service potential to the customer.

Innovation and continuous improvement

To be successful, companies must develop a steady stream of innovative new products and services and have the capability to adapt to changing customer requirements.

Management accounting information systems have begun to report performance measures relating to innovation. Examples include:

● the total launch time for new products/services;

● an assessment of the key characteristics of new products relative to those of competitors;

● feedback on customer satisfaction with the new features and characteristics of newly introduced products and the number of new products launched;

Organizations are also attempting to enhance customer satisfaction by adopting a philosophy of continuous improvement.

Benchmarking is a technique that is increasingly being adopted as a mechanism for achieving continuous improvement.

Allowing employees to take such actions without authorization by superiors has come to be known as employee empowerment

Managing customer value: Attribute costing

Attribute costing involves costing the attributes provided by a product that customers desire.

Attribute costing” would require accountants to embrace strategic information as well as cost information.

This would entail costing the attributes or characteristics provided by goods and monitoring and reporting these costs regularly.

Information about the demand and cost factors associated with those attributes must be relative to those of current and future competitors.

A firm must continue to offer the cheapest way for consumers to obtain the desired bundle of attributes.

(theory of contestable markets)

This suggests that a company needs to maintain its cost advantage over current and potential competitors to have a sustainable strategy (Baumol, 1982; Baumol et al., 1988).

-This requires accountants to adopt a more external focus to cost analysis

Practice Question

Describe with relevant examples the key success factors that directly affect customer satisfaction.

Managing corporate value (Research)

- What is considered
- Underlying assumptions of each technique
- The key factors
- What are the key activities involved in managing corporate value within an organization?
- Benefits of managing the corporate value, and what challenges or limitations might organizations face

Planned Exam Instructions

Course works	
Complete at least four (4)	**40% Final Grade**

Final Exam (Four Questions)	
Section A: One Compulsory Question (40%)	Section B: Three Questions (Answer at least 2) 30% Each

Final Grades	
Course works (40%)	Final Exam (60%)